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Senior Floating Rate Loans: A Low-Cost Hedge Against Inflation

Where to find yield without duration when inflation is elevated.

Headline CPI inflation in the U.S. came in at 7.5% year-over-year in January 2022, its highest level since the mid-1980s. Before the Russia-Ukraine conflict escalated, market participants held the view that the Federal Reserve was well behind the curve on rate hikes as the yield on the 10-year U.S. Treasury reached a near-term peak of 2.05% on February 15. While expectations for rate increases have moderated somewhat given the incremental uncertainty created by the conflict, central bankers have indicated that they still need to fight higher trend inflation. While inflation expectations have remained relatively well behaved considering the recent outsized CPI prints and elevated commodity prices, some central banks such as the Bank of England and Bank of Canada have already begun hiking rates, while others, including the Fed and European Central Bank, have signaled that rate hikes could happen very soon.

How should investors take into account the current environment and outlook when considering fixed income allocation, given that inflation remains elevated and many fixed income sectors have significant duration risk?

Much Higher Inflation and Real GDP Growth Remains Above Trend. Earlier in the cycle, unleashed pent-up demand from high savings, positive wealth effects, multiple rounds of fiscal stimulus and a tight labor market propelled real economic growth and inflation to long-term highs. Real GDP growth has since moderated from elevated levels, but inflation has continued to surprise to the upside.

- U.S. real GDP growth forecasts from economists are still in the 3.5 – 4.0% range for 2022, while trend or potential GDP growth is around 2.0%. Above-trend growth for an extended period, which was the case for the past six quarters, plus the bottlenecks associated with a tight global supply chain have continued to push inflation higher.
- Global supply/demand imbalances have caused bursts of much higher inflation in some sectors and goods categories.
- The Russian invasion of Ukraine has pushed oil, natural gas and several soft commodity (e.g., wheat, corn, soybeans) prices even higher, which will act as a "tax" on real GDP growth, but will likely present more fuel for already high headline CPI inflation.

Rising Short (and Long) Rates. The short end of the yield curve has moved materially higher based on recent central bank communications, which spurred an upward shift in the number and magnitude of rate hikes implied by fed fund futures, even though those expectations have been ratcheted back due to the ongoing military conflict. The yield on three-month U.S. Treasuries ended 2021 at 0.06%, increased to a recent peak of 0.43% on February 14 and, as of February 28, stood at 0.35%. The yield on the bellwether 10-Year U.S. Treasury reached a peak of 2.05% on February 15 and as of the end of February was 1.83%. Needless to say, the expectation is for higher interest rates, which, given loans' floating rate feature, should be beneficial to potential returns for the asset class.

In prior periods dating back to 1999 where the 10-Year U.S. Treasury yield rose by 100 basis points or more, the S&P Leveraged Loan Index outperformed the Barclays U.S. Aggregate Bond Index seven out of seven times (see display).

LOANS OUTPERFORMED THE BROADER BOND MARKET IN PAST PERIODS OF RISING INTEREST RATES

Periods when 10Y UST yields increased by more than 100 bps		Annualized index total returns when 10Y UST yields increased by more than 100 basis points			
		Loans	US Agg	10Y UST Index	5Y UST Index
1/31/1999	1/31/2000	4.10%	-1.85%	-9.61%	-3.83%
5/31/2003	5/31/2004	7.59%	-0.44%	-5.38%	-2.26%
6/30/2005	6/30/2006	6.21%	-0.81%	-5.79%	-2.34%
12/31/2008	3/31/2010	44.66%	6.21%	-7.14%	0.09%
7/31/2012	12/31/2013	6.40%	-1.14%	-6.22%	-1.65%
7/31/2016	10/31/2018	5.39%	-0.94%	-4.61%	-1.88%
7/31/2020	2/15/2022	7.49%	-2.66%	-6.26%	-3.22%
	Average	**11.69%**	**-0.23%**	**-6.43%**	**-2.16%**
Average Excluding Post-Global Financial Crisis*		**6.20%**	**-1.31%**	**-6.31%**	**-2.53%**

*Average Excluding Post-Global Financial Crisis excludes the period from 12/31/2008 to 3/31/2010.

Source: Neuberger Berman, S&P LCD and Bloomberg. Data as of February 28, 2022. Indexes used include the S&P Leveraged Loan Index, the Bloomberg US Aggregate Bond Index, the ICE BofA Current 10-Year US Treasury Index and the ICE BofA Current 5-Year US Treasury Index. Indices are unmanaged, are not available for direct investment and are not subject to fees and expenses typically associated with managed accounts or investment funds. **Historical trends do not imply, forecast or guarantee future results.** Information is as of the date indicated and subject to change without notice. Nothing herein constitutes a prediction or projection of future events or future market behavior.

Why Senior Floating Rate Loans and Why Now?

Given higher inflation and rising interest rates, where can investors find durable income with lower duration and lower volatility within fixed income? We believe senior floating rate loans offer an appealing solution, where suitable. Key characteristics include:

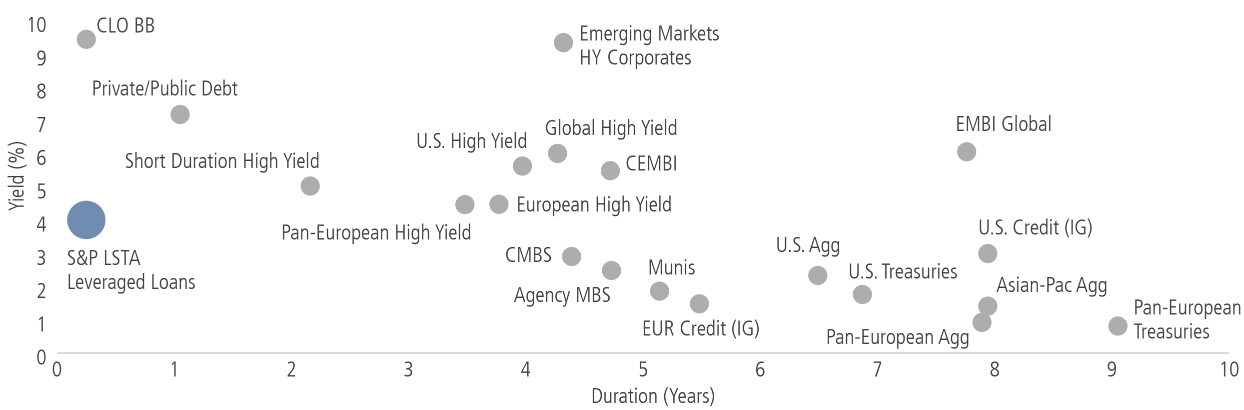
- Attractive yield with very low duration, providing a cost-effective, inflation-hedged fixed income solution, which is critical in the current environment.
- Senior secured position in the capital structure with favorable return of capital to investors, durable income generation and lower volatility than other higher-yielding fixed income.
- Supportive supply/demand factors, solid issuer fundamentals and near-record-low default rates.

An experienced active manager, such as Neuberger Berman, engaging in fundamental credit research and who seeks to minimize credit deterioration and avoid default risk, is key in an environment where credit dispersion has risen, as is the case currently.

Focus on Yield Without Duration Is Key in This Environment

Senior floating rate loans currently offer the most attractive yield relative to duration among fixed income alternatives.

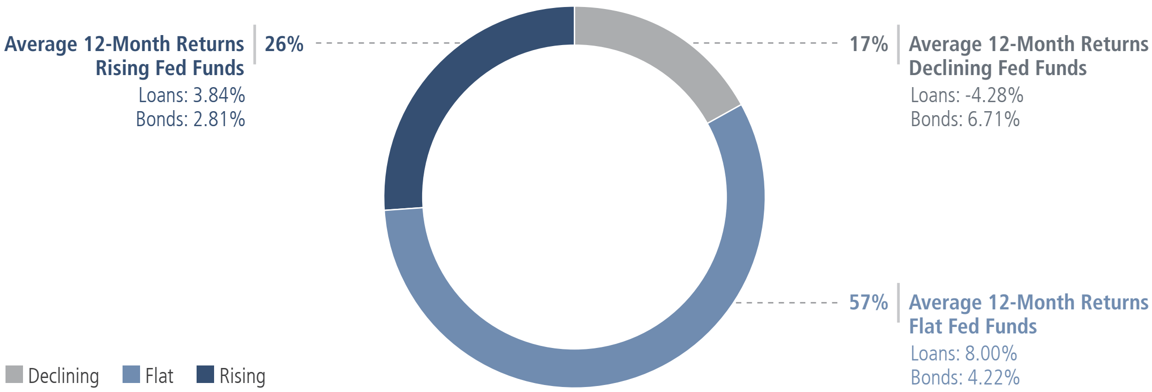
MAJOR FIXED INCOME INDICES – UNHEDGED YIELDS AND DURATION



Source: Bloomberg. Data as of February 28, 2022. Indices used were Bloomberg Barclays Global Aggregate Index for Global Agg, Bloomberg Barclays U.S. Aggregate Bond Index for U.S. Agg, Bloomberg Barclays Pan-European Aggregate Index for Pan-European Agg, Bloomberg Barclays Asian-Pac Aggregate Index for Asian-Pac Agg, Bloomberg Barclays Global Treasuries Aggregate Index for Global Treasuries, Bloomberg Barclays U.S. Treasuries Aggregate Bond Index for US Treasuries, JPM CLOIE BB Index for CLO BB, Bloomberg Barclays U.S. Credit Index for U.S. Credit (IG), Bloomberg Barclays EUR Credit IG Aggregate Bond Index for EUR Credit (IG), Bloomberg Barclays U.S. High Yield Aggregate Index for U.S. High Yield, Bloomberg Barclays U.S. High Yield Ba/B 1-5 Years Index for U.S. Short Duration High Yield, Bloomberg Barclays Pan-European High Yield Aggregate Index for Pan-European High Yield, JPM EMBI Global Diversified Index for EMBI Global, JPM CEMBI Diversified Index for CEMBI, Bloomberg Barclays Muni's Aggregate Index for Muni's, Bloomberg Barclays CMBS Aggregate Index for CMBS, Bloomberg Barclays Agency MBS Aggregate Bond Index for Agency MBS, and S&P LSTA Leveraged Loan Index for Floating Rate Loans. The CLO BB duration has been overwritten with the duration from the S&P Leveraged Loan Index as calculated by Aladdin. **Historical trends do not imply, forecast or guarantee future results.** Nothing herein constitutes a prediction or projection of future events or future market behavior. For illustrative and discussion purposes only.

Senior floating rate loans have most typically been seen as a solution in periods when the Fed is increasing policy rates, but it's not so widely known that the asset class has also seen good historical returns in flat policy-rate environments. In fact, the S&P Leveraged Loans Index historically has outperformed the broader bond market—measured by the Bloomberg Barclays U.S. Aggregate Bond Index—in both flat and rising policy rate environments.

U.S. LOANS AND AGGREGATE BOND INDEX AVERAGE 12-MONTH RETURNS IN RISING, FLAT AND DECLINING RATE ENVIRONMENTS



Source: Bloomberg. As of February 28, 2022. Monthly observations from January 1999 to February 2022 based on 278 observations; The percentages of the pie chart are the percentage of time that the policy rate regime has been in place over the total period. Indexes used include the S&P Leveraged Loan Index for loans and Barclays U.S. Aggregate Bond Index for bonds. Based on historical average 12-month returns in three different interest rate environments as defined by the effective federal funds rate and FOMC policy regimes. **Past performance is no guarantee of future results.**

Loans Are Senior-Secured and Provide Durable Income Generation

The senior-secured position of a loan in the capital structure helps to reduce credit risk. Loan investors have priority for repayments—in the event of a default—before stock or bond holders, and loans hold a first-priority lien on the assets of the borrower.

Over the past 33 years, the average recovery rate on loans that default has been roughly 65 – 70%, meaning that credit losses amount to 30 – 35% of the 3% average annual default rate, or about 1%.[1] This implies that about 99% of principal has been returned to investors over a period that has included a number of recessions, which means that almost all the annual income that is generated from a portfolio of loans has been retained by investors.

The income component of total return has historically aided in providing stability to overall returns as the significant and regular distributions have helped dampen any potential mark-to-market volatility on underlying loan prices.

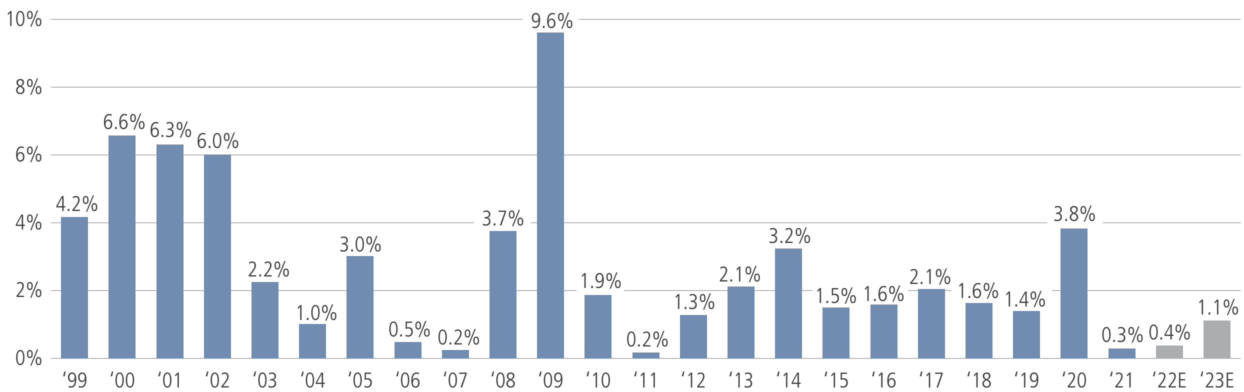
[1] Source: JP Morgan, data through December 2021.

Technical Tailwinds and Improving Issuer Fundamentals Favor Loans

Retail investor and CLO demand for loans set records in 2021. Year-to-date through February, inflows continued into floating rate loan funds at a cumulative rate of $13.6 billion.

Improving issuer fundamentals—such as declining default rates, solid EBITDA growth and ample liquidity on balance sheets—in addition to the near-zero exposure to Russia are also factors bringing investors to consider allocations to senior floating rate loans.

S&P LEVERAGED LOAN INDEX PAR-WEIGHTED ANNUAL DEFAULT RATES



Source: Neuberger Berman, S&P Global. Data as of February 28, 2022. Data represented by S&P/LSTA Leveraged Loan Index. Information is as of the date indicated and subject to change without notice. **Historical trends do not imply, forecast or guarantee future results.** Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed.

- Defaults continued to decline toward all-time lows. February saw the loan market default rate decline to just 0.19% on a trailing 12-month par weighted basis, which is down 398 basis points from the COVID-19 peak and just four basis points above the all-time record low default rate.
- The bottom-up default estimate for 2022 and 2023 from our research team stands at 0.38% and 1.11%, respectively, which is well below the long-term average of 3%.
- Loan issuers overall cut costs aggressively in 2020, had very large rebounds in EBITDA and free cash flow in 2021, raised significant liquidity via refinancings and had lowered overall borrowing costs, which set them up to better withstand any input cost pressures. While real GDP growth is expected to moderate in 2022 and most issuers are able to pass on input cost increases to consumers, we believe issuers in the loan market are generally well positioned to benefit as nominal topline growth will likely remain solid in the coming quarters. That said, loans are an asset class that requires active management for successful investment outcomes, as credit selection and avoiding credit deterioration have been key drivers of returns over time.

Well-Positioned for Higher Inflation

Given that duration weighs heavy on longer-dated fixed income and that the repricing of monetary policy expectations will likely continue to push interest rates higher, we believe positioning in fixed income will become increasingly important. Senior floating rate loans are an attractive option to consider for investors when looking for total return opportunities without duration risk.

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